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C O N F I D E N T I A L SECTION 01 OF 05 CARACAS 003131

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ENERGY FOR CDAY, DPUMPHREY AND ALOCKWOOD
NSC FOR DTOMLINSON

E.O. 12958: DECL: 10/06/2016
TAGS: ECON ENRG EPET VE
SUBJECT: MEP PRESENTS TERMS FOR STRATEGIC ASSOCIATION MIGRATION

REF: CARACAS 2667

Classified By: AMBASSADOR WILLIAM R. BROWNFIELD, FOR REASON 1.4 D

¶1. (C/NF) Chevron Latin America Upstream President Ali Moshiri (strictly protect throughout) and ExxonMobil Venezuela (XM) President Tim Cutt (strictly protect throughout) paid separate calls on the Ambassador the week of September 29 to update him on the upcoming forced migration of the Faja strategic associations (of which they are major stakeholders) to PDVSA majority held joint-ventures. Moshiri said that Chevron's strategy would be to not make any new serious investment commitments in Venezuela for the time being and slow-roll the strategic association migration. Moshiri was confident about Chevron's negotiating position and underscored his view that only U.S. IOC's were capable of providing the technology and human resources to fully develop the Faja. Cutt, who a day earlier had received written terms for the Cerro Negro migration (see para 10 - strictly protect) from MEP VM Mommer, said the BRV knew clearly where it wanted to go but had no clue on how to get there. (Note: XM owns 41.67% of Cerro Negro, along with BP (16.67%) and PDVSA (41.67%) respectively. End Note). The BRV, according to Cutt, was seeking a majority position in primary/upstream activities, would take a minority position in upgrading, and sought an increased recovery rate for Cerro Negro, but had clearly not thought through how to compensate XM for lost value. Cutt added that the BRV was determined to have some type of transition agreement completed by December 15 with additional terms likely to be worked out by June 2007, in order to declare that the BRV regained full-sovereignty over the oil business during 2007 (during 2006 the BRV migrated the Operating Service Agreements). Over the next 2-3 months, XM would decide the course of action for their investments in Venezuela -- compensation being key. End Summary.

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Chevron Plans No New Major Investment for the Time Being
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¶2. (C/NF) Moshiri was optimistic about Chevron's bargaining position regarding the migration of the strategic associations to joint ventures but acknowledged each company,s position was different. He said that for the time being Chevron would hold back on making additional large investments in the Venezuelan energy sector until things cleared up. Moshiri said that Chevron planned to slow-roll the migration process by overwhelming the Ministry of Energy and Petroleum with technical and financial issues. He added, confidently, that U.S. companies were the only ones that could supply the technology and human resources necessary to develop and maintain production at the strategic associations. As an example, he noted that the BRV needed Chevron technology to run the Hamaca upgrader which converts oil from 9 API to 28 API. He also said that a senior PDVSA official groused to him privately that only 10% of PDVSA employees currently have college degrees, 40% have high school degrees, and 50% have no degree, and 50% of his time was spent "finding jobs" for people. (Comment: We do not share Moshiri's view that only U.S. firms have the necessary technology and resources for Faja projects. Shell, which has significant extra-heavy crude oil experience, is currently in negotiations with the BRV for a Faja project. End Comment.)

¶3. (C/NF) Moshiri added that the upcoming migration was too complex and would not be done by the end of this year. (Note: In a July meeting with econoffs, Moshiri said Chevron would be willing to sign an MOU migrating the strategic

associations to BRV majority-held-joint-ventures since he believed the agreement would be non-binding. Such an agreement, according to Moshiri, would not threaten Chevron's bargaining position and would provide the BRV with the political capital it needed for the elections. End Note.) The BRV's objective, per Moshiri, was to pick up 51% of the strategic associations equity "without paying for it," and to breakout upstream from downstream but didn't want a big position in the upgrader. He said he had warned MEP Minister Ramirez that Chevron would notify the strategic association's lenders and they would call the loans if this breakout occurred. (Comment: It remains to be seen whether lenders would call the loans. Representatives from Fitch told Petroleum Attache in early September that they were not sure if lenders or financial markets would view a change in the association's equity structure as a default if the associations could meet their debt payments. End Comment.)

Decision Making and Decision Makers

¶4. (C/NF) Moshiri viewed decision-making on petroleum issues as going from MEP VM Mommer directly to Chavez. Mommer, according to Moshiri, comes to the table with the view that everything must be under the control of the Ministry and PDVSA and with a general lack of knowledge about how the oil business works. He stressed to the Ambassador that "we must remind everyone (that) Venezuela is not Saudi Arabia... (and that) people tell Chavez what he wants to hear," (read: oil production costs are much higher). For now, Chevron plans to keep future investment decisions in Venezuela in "the conceptual phase," and not spend billions. It also would not agree to any type of contract that could be disputed by the BRV. Chevron's investment would likely also shift, in the interim, to Trinidad and Brazil. This approach, according to Moshiri, was the right business decision for Chevron until after the December national elections. He added that if the BRV gets the feeling Chevron is feeling less cooperative then "they'll make our life miserable, but we'll manage."

¶5. (C/NF) On other issues, Moshiri claimed that if oil

revenue fell by 20-30% the country would be "bankrupt in 12 months." He also noted that with the migration of the former Operating Service Agreements to joint ventures, that Chevron was now only responsible for 40% of the capital for those projects.

Meeting with Exxon-Mobil

¶6. (C/NF) Cutt told the Ambassador on September 28 that the BRV was seeking a majority position in primary/upstream activities, would take a minority position in upgrading, and sought increased recovery from Cerro Negro, but had clearly not thought through how to compensate XM for lost value (see para 10 "terms sheet" provided by VM Mommer to XM (strictly protect). Cutt said the BRV was determined to have some type of transition agreement completed by December 15 with additional terms likely to be worked out by June 2007, (Note: XM owns 41.67% of Cerro Negro, along with BP (16.67%) and PDVSA (41.67%) respectively. End Note). What was clear to Cutt, based on his meeting a day earlier with Mommer, was that the BRV knew where it wanted to go, but had no idea on how to get there (read: how to overcome the myriad of financial and technical issues as well as addressing how XM

would be adequately compensated for its lost value stemming from the migration.) As an example, Cutt noted that the recovery rate in the Cerro Negro concession area stood at around 4% and could probably reach 11%; however, PDVSA wants to take it to 20%, but did not understand that "the incremental cost of 9% was four-fold." He added that XM viewed the concession as already permitting a daily production limit in excess of 120 kbd. The BRV's proposition is basically it will pay for increased equity in the strategic association by allowing it increased production. Mommer, in Cutt's view, had no clear idea on the exponential investment outlays that would be required for additional production. PDVSA has established working groups to deal with issues such as financing, recovery, and net-present value issues, however, XM has not yet decided on their level of participation. Cutt also didn't think Minister Ramirez would give Mommer room to back down on the basic conditions established in the terms sheet.

¶7. (C/NF) Cutt pointed out that there were additional financial issues that could also complicate the transition. The BRV was seeking a waiver of existing claims in the terms sheet, but it wasn't clear whether resolution of this issue would be insisted upon for December or be put-off until next June. XM currently has USD 2 billion in claims, and when Cutt reminded Mommer, it appeared he had forgotten. Cerro Negro had also obtained approximately USD 600 million in loans from commercial banks which have financing covenants that govern changes in equity structure (reftel). Banks could put the loans in default (Note: Cutt noted that while XM had already notified the lenders, that "surprisingly there had been no reaction. End Note.)

¶8. (C) Cutt said that XM Dallas would decide over the next 2-3 months on whether to take this issue to arbitration or simply to "wallow-through" and keep a toe-hold in Venezuela. He noted that XM's chairman had said recently that Venezuela was not a place he was interested in investing in the short-term. (Note: XM's Venezuela exposure as a percentage of total operations is approximately 1%. End Note.) While Cutt had no doubt that XM would win any arbitration, he acknowledged that it really didn't get them much; he also acknowledged there wasn't much interest is just running the upgrader. The real issue remained how was XM going to be compensated for lost value. Cutt also revealed that while the BRV has not questioned the legality of the strategic associations which were approved by the National Assembly, Mommer suggested that in the case of Cerro Negro XM had not

obtained a final ministry approval following legislative approval.

¶9. (C/NF) On other subjects, Cutt reiterated Moshiri's view that Mommer knew very little about the technical aspects of the migration, and that Mommer would be leaving the Ministry at the end of the year for a European posting. However, in Cutt's opinion, Mommer was at least a somewhat reasonable interlocutor. Cutt acknowledged Cerro Negro's operation could be run by PDVSA handling the upstream and other players (presumably an IOC such as Shell) operating the upgrader.

¶10. (SBU/Business Confidential/NF)
(Begin Text)

Cerro Negro
August 2006.
Non Binding Terms for the Migration of the Associations.
¶1. Form of the Association: The existing project shall be

divided in two parts: (i) the primary activities, which will be developed by a mixed enterprise in accordance with article 33 of the Organic Hydrocarbons Law (the "Primary Activities Mixed Enterprise:) and (ii) the upgrading activities which shall be developed by a conventional mixed enterprise (the "Upgrading Mixed Enterprise").

¶2. Capital Structure: The Primary Activities Mixed Enterprise shall be owned by PDVSA with at least a minimum 51% and by ExxonMobil and BP with a maximum of 49%. In the Upgrading Mixed Enterprise, PDVSA can be a minority shareholder.

¶3. Operations: The Primary Activities Mixed Enterprise shall be the operator for the heavy and extra heavy crude oil production. The upgrader can be operated by ExxonMobil and BP directly or through the Upgrading Mixed Enterprise.

¶4. Purchase/sale Contracts and heavy and extra heavy crude oil transfer prices: All the crude oil produced by the Primary Activities Mixed Enterprise shall be sold to PDVSA at formula prices that reflect market price less a margin to be determined. PDVSA shall have a "back to back" contract to transfer at formula price the crude oil produced to the Upgrading Mixed Enterprise as long as the upgrader is functioning and has sufficient capacity. PDVSA shall market the remaining production with the understanding that any heavy and extra heavy crude oil production that cannot be upgraded due to the lack of capacity of the upgrader or because it is out of service for any cause, may be subject to restrictions if the Ministry so decides.

¶5. Purchase/sale Contracts and upgraded crude oil transfer prices: The upgraded crude shall be sold by the Upgrading Mixed Enterprise at market prices, including sales to the parent companies of the partners. A committee of experts shall review the existing purchase and sale contracts.

¶6. Expansion: The primary Activities Mixed Enterprise will no longer be subject any more to the production limit of 120 KBD. The Upgrading Mixed Enterprise may increase its capacity to 165 KBD approximately.

¶7. Area: The area for the Primary Activities Mixed Enterprise shall be determined by the Ministry of Energy and Petroleum through a Resolution that shall be published in Official Gazette.

¶8. Recovery Factor: The Primary Activities Mixed Enterprise commits to immediately develop a pilot project of 20 KDB steam-enhanced production in order to significantly improve the recovery factor of the area.

¶9. Term: The Primary Activities Mixed Enterprise shall have

a 25 years duration and the Upgrading Mixed Enterprise shall have a duration the same remaining term of the existing project.

¶10. Special Advantage: A special contingent advantage (payment to the State) shall be applied in case the sum of the royalties, the extraction tax and the income tax paid by the Primary Activities Mixed Enterprise in less that 50% of the value of the crude oil production.

¶11. Waiver of claims: The parties shall mutually release each other, in an appropriate manner of all outstanding claims.

¶12. Bonus: ExxonMobil and BP shall pay the Ministry of Energy and Mines a bonus in an amount to be negotiated considering the value added by the expansion to the project.

¶13. Authorizations: In accordance with the Organic Hydrocarbons law the new projects shall be presented for approval of the National Assembly. (End Text)

¶11. (C) Comment: As stated in reftel, the BRV wants some sort of agreement on the migration by mid-December. However, we believe they will want the agreement before the presidential elections on December 3. The type of agreement (binding, non-binding transitory, etc) that the BRV will be satisfied with remains to be seen. The political statement of regained sovereignty for the Venezuelan oil sector is paramount, however, and not something the BRV will back down from.

BROWNFIELD